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Commercial Bank's Credit Extension to the Private Sector in Lesotho has Recently Surged

What are the Factors?...........

Introduction

The economic importance of finance is widely acknowledged though there are some conflicting views regarding the direction of causality between finance and economic growth. On the one hand is the argument that finance or credit extension responds to changing demands by the real sector implying that economic activity stimulates finance. On the other hand is the proposition that finance causes growth. Whether private sector growth leads finance or vice versa, what remains uncontestable is that finance does have a significant role to play in supporting growth of the private sector and expansion of the overall economic activity. However, as demonstrated by the global financial crisis that started in 2007 leading to the global recession, credit growth could be deleterious rather than growth enhancing.

It is for this reason that it is important to understand the dynamics of private sector credit growth in Lesotho. This article assesses how private sector credit extension (PSCE) has evolved in Lesotho and provides explanations for the observed movements. It is concluded by analyzing the implications of the developments in the PSCE for Lesotho's economy.

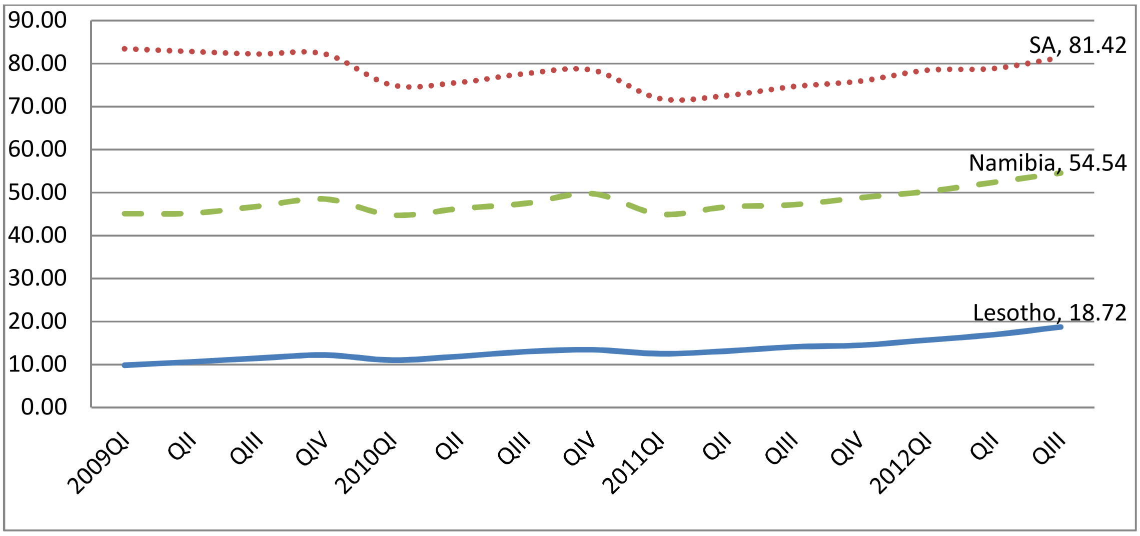
Evolution over Time and the Explaining Factors

PSCE by the commercial banks in Lesotho has historically been subdued. The historical weakness in Lesotho's PSCE could have reflected commercial banks' risk aversion coupled with low credit demand by the private sector. On the one hand, there is a view that Lesotho's weak PSCE is attributable to low willingness by the commercial banks to extend credit due to a number of factors, including lack of collateral by borrowers, failure by businesses to submit bankable business plans and unavailability of information for verifying credit worthiness of borrowers. On the other hand is the philosophy that demand for credit by the private sector was weak reflecting depressed domestic business investment due to, amongst other things, low interest in self-employment in favor of being hired, lack of skills in the areas of business management resulting in stunting and/or collapse of micro, small and medium enterprises (MSMEs). Lesotho's business sector is dominated by foreign owned business enterprises that are financed through foreign capital inflows. It also reflected low demand by households, probably due to low incomes, lack of collateral and information and the not so flexible loan terms.

However, the PSCE has recently picked up, with its speed accelerating during 2012. It rose by 6.4 per cent, on average, from the second quarter of 2009 to the third quarter of 2012 compared with an average of 8.9 per cent in the first three quarters of 2012. For the first time in Lesotho's history, the PSCE registered a double digit quarterly increase of 10.5 per cent in the quarter ending in September 2012. However, notwithstanding the accelerated recent upward trend, Lesotho's PSCE as a percentage of gross domestic product (GDP) remains very low relative to Namibia and South Africa (SA), as depicted in Figure 1 below. The national strategic plan 2012/13 – 2016/17 identifies lack of access to credit as one of the major challenges for Lesotho.

FIGURE 1: PRIVATE SECTOR CREDIT

(Percent of GDP)

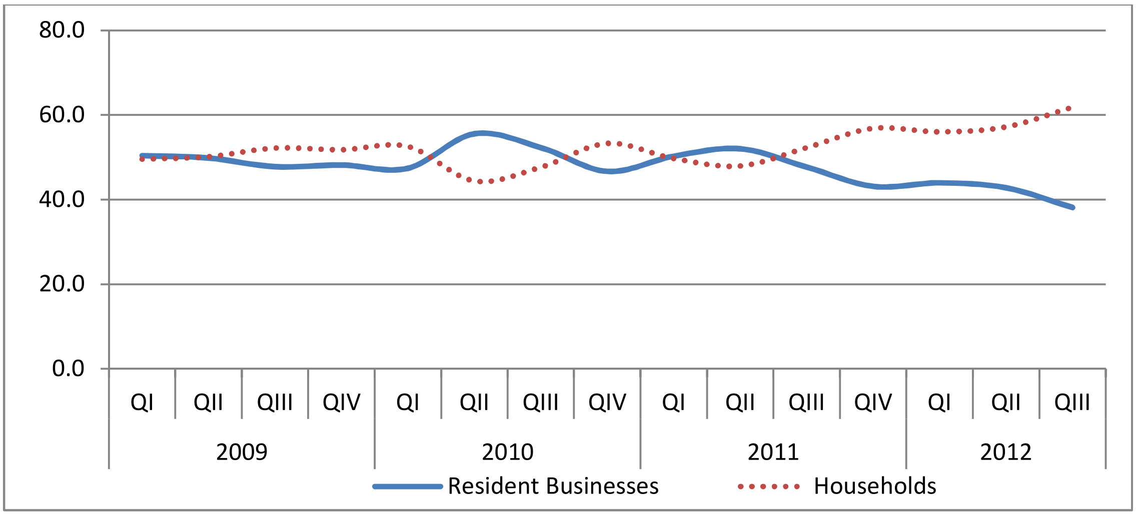


Source: The relevant Central Banks' websites

The recent rise in the PSCE reflects both supply and demand side factors and policy initiatives aimed at enhancing access to credit.

On the supply side, the commercial banks have in recent years been introducing new loan products with more flexible terms, including increased loan ceilings and long payment periods. However, the focus of banks has been biased towards households. In Lesotho, private sector credit used to be more or less evenly distributed between households and business enterprises, until September 2011 when they started to diverge. This divergence was mainly at the back of a faster growth in credit extended to households compared to credit extended to business enterprises. Credit to households increased by an annual rate of 56.2 per cent in September 2012, while credit to business enterprises rose by 5.6 per cent during the same period. Consequently, as a share of total private sector credit, household credit rose from 52.3 per cent in September 2011, to 61.9 per cent in September 2012. On the contrary, credit to business enterprises, as a share of total private sector credit declined from 47.7 per cent to 37.3 per cent. On the demand side, households have responded positively to the increase in the supply of loans. This may be a reflection of increased confidence of households in their ability to service the loans, attributable to rising disposable incomes and the easy loan payment conditions.

FIGURE 2: THE DISTRIBUTION OF PRIVATE SECTOR CREDIT



Source: Central Bank of Lesotho

The government of Lesotho has also taken policy measures that may have contributed to the surge in credit to the private sector. Women were empowered through the enactment of the Legal Capacity of Married Persons Act 2006, which is meant to bring about equality between spouses married in community of property. This Act effectively overturned the hitherto requirement for married women to acquire their husbands' consent to validly enter into any contracts. Amongst other things, this Act gives women the right to access credit, to sue and be sued and to acquire immovable property in their own name. In addition, the land reform process was engaged into, resulting in a new law, the Land Act 2010, which, amongst other things facilitates the use of land as an economic asset, for example as collateral by borrowers. These reforms may have contributed to the increase in credit to households.

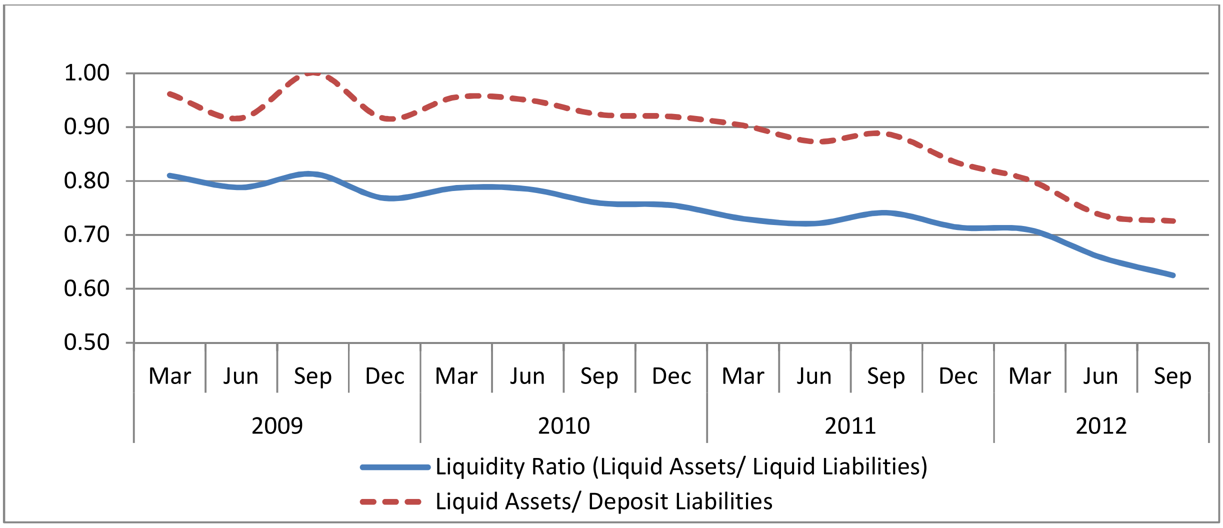
The Government signed a Memorandum of Understanding (MoU) with commercial banks on the establishment of a M50 million Partial Credit Guarantee Fund (PCGF) in May 2012. The Lesotho National Development Corporation (LNDC) also established a Partial Credit Guarantee Scheme towards the end of 2012. The main objective of these facilities is to support investors who wish to start or expand MSMEs as well as large businesses but are not able to access financial assistance from the Banks due to lack of collateral. The partial guarantee ensures that the banks will be able to recover a portion of their money in the event of a default. Consequent to this, the domestic commercial banks have recently begun to introduce easily accessible loan instruments for the business sector, especially the MSMEs. Nonetheless, these initiatives are yet to bear fruit as they are a very recent phenomenon.

Private Sector Credit Extension versus Commercial Bank's Capacity to Extend Credit

The capacity of Lesotho's commercial banks to extend credit is very high by any standards, though it has recently deteriorated in line with the increase in credit extension. The deposit liabilities have increased from M5 198.8 million in March 2009 to M6 103.70 million in September 2012, contributing to the increase in the funds available to the banks to lend out. In addition, as depicted in Figure 2 below, Lesotho's commercial banks are highly liquid. The consequence of the increase in deposit liabilities has been the high liquidity of commercial banks as indicated by significant levels of liquid assets, which they invest in domestic Treasury bills and other instruments in SA. Their liquid assets, as a percentage of GDP, were estimated at 24.2 per cent in September 2012. The liquidity ratio, which measures the ability of the banks to honour their short-term obligations should they be required to do so immediately, was 60.0 per cent in September 2012.

The commercial banks keep a considerable share of their deposits in liquid assets rather than loaning them out to the private sector, hence the low credit extension relative to the high liquidity. In addition, the bulk of their holdings of liquid assets, estimated at 54.0 per cent in September 2012, are invested with South African banks, thus improving the latter's ability to extend credit to economic agents in SA. As such, the surplus funds of Lesotho's economic agents are contributing to the economic growth and development of SA at the detriment of private sector growth, hence its contribution to economic growth in Lesotho. Because they are sitting on a lot of liquidity, the commercial banks in Lesotho do not borrow much from foreign sources, hence the low level of liabilities to non-residents, which hoovers around 1.0 per cent of GDP in most of the quarters, falling to around 0.5 per cent of GDP in some quarters. It was estimated at 1.0 per cent of GDP in September 2012. Because it is so low, it implies that the commercial banks have a lot of room to borrow from foreign sources and finance domestic private investments in Lesotho.

FIGURE 3: SELECTED LIQUIDITY RATIOS



Source: Central Bank of Lesotho

Implications for Lesotho’s Economy

The theoretical and empirical literature generally indicates that financial sector development and increased credit availability contribute to economic growth and development. By easing households and firms’ liquidity, credit extension leads to increased consumption and investment. Therefore the recent surge in PSCE in Lesotho could be considered beneficial. However, there is a caveat. Empirical evidence appears to generally suggest that household credit has a short lived impact as it does not have any effect on medium and long-term economic growth and that it even reduces long term growth in some instances. On the contrary enterprise credit is generally argued to ease firms’ liquidity constraints hence leading to establishment of new firms and expansion of existing ones. It enhances productive capacity of the economy, stimulates an increase in private savings and investment, thus enhancing economic growth. Rapid credit growth to the private sector could spark a banking crisis and household credit has a particularly stronger effect in this regard than business enterprise credit. It is in this regard that the skewed nature of Lesotho’s PSCE as discussed above, is of concern.

2. Extension of the Third Country Provisions in the African Growth and Opportunity Act (AGOA): What Does this mean for Lesotho?

Introduction

The AGOA, signed into the United States (US) law on 18 May 2000, as Title 1 of the Trade and Development Act of 2000, was designed to be a catalyst for industrial development in Sub-Saharan Africa (SSA) countries. AGOA is an American initiative that has created preferential terms of trade on a range of products manufactured in SSA for the US market. Under this arrangement, qualifying exports from African countries like Lesotho enter the US market duty and quota free. Lesotho was declared eligible for trade benefits under AGOA in October 2000, satisfied the AGOA requirements in April 2001 and started exporting apparel under AGOA in the same year. In 2001 and 2002, 98 per cent of Lesotho's exports of textiles and apparel to the US market were AGOA eligible.

The Third Country Fabric (TCF) provision under AGOA, allows lesser developed countries like Lesotho to source fabrics and yarn for production of textiles and clothing for the US market from anywhere in the world. TCF was set to expire in September 2012. However, in August 2012 the TCF provision was extended to September 2015. Thus this article seeks to assess the impact of the uncertainty that prevailed before the TCF provision was extended and possible implications of its extension for Lesotho’s Economy, bearing in mind the time bound nature of the TCF and the entire AGOA program.

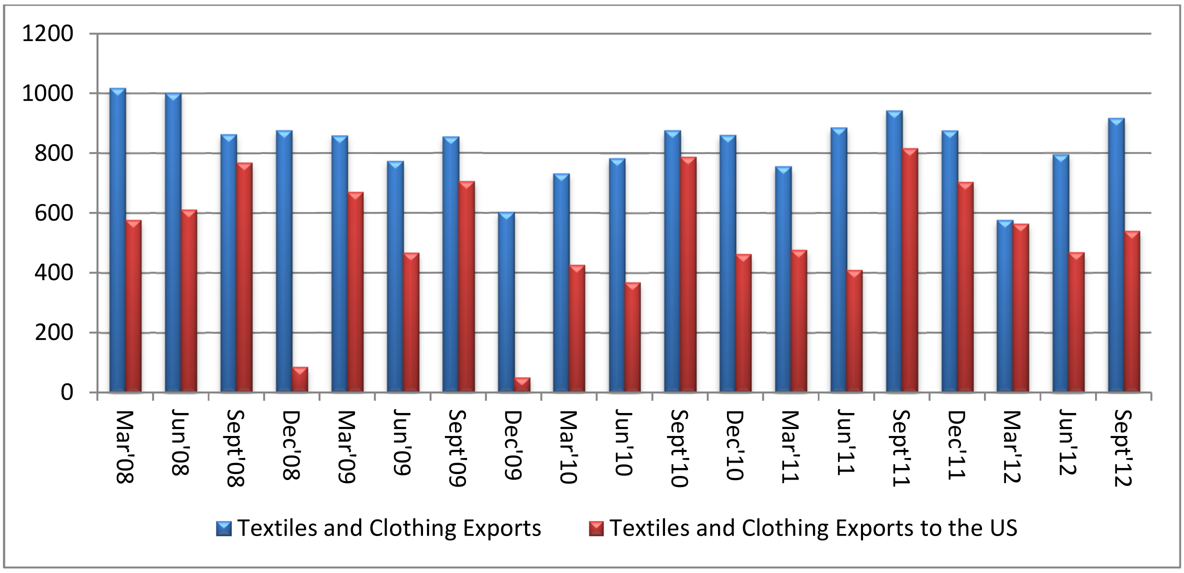
The significance AGOA has had on the Economy

Since Lesotho became eligible for trade benefits under AGOA in 2000 and resumed to export to the US under the same in 2001, Lesotho’s textiles and clothing manufacturing sub-sector has grown substantially imparting a number of benefits to Lesotho’s economy. Amongst other things, it has resulted in an increase in exports, job creation and new investments hence additional boost to the manufacturing sub-sector's contribution to economic growth.

Lesotho's total exports of textiles and clothing have increased from M299.5 million in the first quarter of 2001 to M917.1 million in the quarter ending in September 2012. As depicted in figure 3 below, this mainly reflected a surge in Lesotho's exports of textiles and clothing to the US market. Lesotho's exports of textiles and clothing are highly concentrated with apparel constituting the highest share, estimated at 97.9 per cent of total exports of textile and clothing in March 2012. This makes Lesotho the largest SSA apparel exporter to the US.

FIGURE 4: LESOTHO'S EXPORTS TO THE US

(Million Maloti)



Source: OTEXA- US Department of Commerce

AGOA has also contributed to the increase in foreign direct investment (FDI) in Lesotho. Following the inception of AGOA in Lesotho in 2001, a number of Asian investors came to Lesotho to benefit from duty and quota free access to the US market, resulting in an increase in the number of firms mainly in the textiles and clothing manufacturing sub-sector. In 2002, a denim mill was established in Lesotho. The resultant expansion of the textiles manufacturing sub-sector stimulated an increase in employment for a sizable number of Basotho because it is labour intensive. Employment by the textile and clothing industry grew from around 19 000 in 1999 to around 38 750 in September 2012. In particular, the sub-sector has created jobs for low skilled Basotho, mostly women who in the past were not able to be part of the formal wage employment, thus contributing to the improvement of social lives and poverty reduction. In addition, the sub-sector's contribution to economic growth, particularly the textiles and clothing industry increased from 12.8 per cent in 2000 to an average of 19.4 per cent in 2001, 2002 and 2003. However the sector's contribution to growth declined to 17.23 per cent in 2005 and has remained under pressure ever since due to a number of negative pressures.

Despite the above mentioned benefits, the textiles and clothing industry has experienced a number of challenges that have suppressed its performance somewhat. Consequently, the macroeconomic benefits derivable from the industry have deteriorated. The industry was hit hard by the expiry of the Multi Fibre Agreement (MFA) in 2005, which lifted quota restrictions on exports of textiles and apparel by developing countries to developed countries. The expiry of the MFA opened up the US market for exports of textiles and apparel to Asian countries like China, Bangladesh, Vietnam etc., thus increasing competition for Lesotho. Consequently, Lesotho has been losing market share in the US resulting in a sharp decline in its textiles and clothing exports and employment as several factories closed operations. The appreciation of the domestic currency, the loti against the US Dollar and other major currencies, especially from 2004 to 2006 also affected the industry negatively. The recent global recession also put the industry under pressure. In the run up to the expiry of the TCF, the industry experienced a decline in orders from US buyers. This was because the expiry would mean that Lesotho producers would no longer be able to source fabric and yarn (production inputs) from cheaper Asian suppliers but would have to source them either from the US or other AGOA beneficiaries. Thus it caused a lot of uncertainty as it would mean that exports from Lesotho would be expensive hence uncompetitive.

Evolution of the Third Country Fabric Provision

The TCF provision on fabrics and yarns used to produce textiles for export to the US market under AGOA took effect from October 2000, five months after AGOA was signed into law. It allows SSA countries to import fabrics and yarns for production of textiles and apparel for export under AGOA from countries that are not AGOA beneficiaries. This allows producers to source inputs from the cheapest suppliers. As such it gives them some competitive advantage. Thus the TCF is crucial for the continued survival of Africa's, hence Lesotho's textiles and apparel industry.

The TCF provision was initially set to expire in September 2004, four years after the inception of AGOA. However, AGOA III was signed into law and amongst other things, it extended the TCF provision for lesser developed AGOA beneficiary countries for three years, from September 2004 to September 2007. Further amendments were made on AGOA resulting in, amongst other things, further extension of the TCF provision by five more years from September 2007 to September 2012. It was extended for the third time in August 2012 and this time to expire together with the entire AGOA program in 2015.

Implications for Lesotho's Economy

The TCF provision is a necessary condition for the survival of Lesotho's textiles and clothing industry, especially for the firms that are producing for the US market. It enables them to source production inputs, particularly fabrics and yarn from the most cost effective suppliers around the world. Currently it is cost effective for Lesotho's producers to buy fabric and yarn from Asian producers including China. Without the TCF, Lesotho's producers for export under AGOA would have to source these raw materials either from other AGOA eligible SSA countries or from the US. This would be to Lesotho's disadvantage as inputs from these countries would be much more costly, thus resulting in expensive final products. Lesotho is already loosing competitive advantage and market share in the US's textiles and clothing market to Asian producers, who face relatively lower production costs (labour, utility and transportation costs). The expiry of the TCF provision would mean further loss of competitiveness by Lesotho's producers.

The run up to the expiry of the TCF provision caused widespread uncertainty and speculation for the clothing industry. Consequently, Lesotho's producers faced a decline in orders by US based buyers in the months before the provision was extended, resulting and job shedding and a decline in exports. Mostly affected were producers of knit garments as there is currently no knit fabric mill in Lesotho.

As mentioned earlier, the TCF provision is set to expire together with the entire AGOA program in 2015. This means that after the expiry, Lesotho and other SSA countries will have to compete on an equal footing with everybody else for the US market. This will be tough competition for Lesotho's producers, especially because they have been losing their market share in the US to Asian producers despite the preferential treatment. This calls for diversification of manufactured products and export markets.

TABLE 1: SELECTED MONETARY AND FINANCIAL INDICATORS+

	2012		
	July	**Aug**	**Sept**
1. Interest Rates (Percent Per Annum)			
1.1 Prime Lending Rate	10.08	9.92	9.92
1.2 Prime Lending Rate in South Africa	8.5	8.5	8.5
1.3 Savings Deposit Rate	1.57	1.57	1.57
1.4 Interest Rate Margin (1.1-1.3)	8.51	8.35	8.35
1.5 treasury Bill Yield (91-day)	5.08	4.99	4.94
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	6928.35	6813.09	6783.54
2.2 Net Claims on Government by the Banking System	-3278.14	-2924.38	-2650.23
2.3 Net Foreign Assets-Banking System	10458.21	9813.59	9762.74
2.4 CBL Net Foreign Assets	8094.31	7836.37	7889.32
2.5 Domestic Credit	-438.189	113.269	427.754
2.6 Reserve Money	1024.31	1040.66	1020.84
3. Spot Loti/US$ Exchange Rate (Monthly Average)	8.26	8.26	8.28
4. Inflation (year to year percentage change)	5.7	5.3	5.8
	2012		
5. External sector (Million Maloti)	**QI**	**QII**	**QIII**
5.1 Current Account Balance (Excl. LHWP)	-2460.18	-1632.39	-520.40
5.2 Capital and Financial Account Balance (Excl. LHWP)	988.58	1092.29	1039.59
5.3 Reserve Assets	770.08	-227.12	-1098.93

Source: Central Bank of Lesotho